GUGGENHEIM

The Diversification Dilemma

Tactical Management and Today's Evolving Markets

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I. The Diversification Dilemma

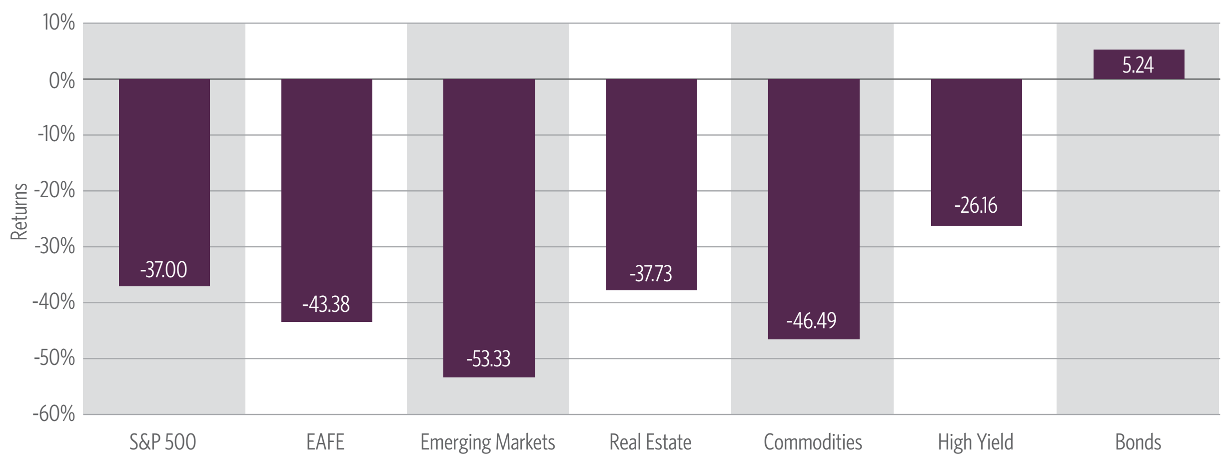
How diversified are investor portfolios? The answer is that, when diversification is needed most, portfolios may not be as diversified as investors assume.

The Great Recession, which included 2008, taught investors this valuable lesson. When it was essential to be diversified, investor portfolios were often found lacking. In looking at the chart below, we see that very few asset classes, other than investment grade bonds, provided investors a shelter from the storm.

In this paper, we will explore the concept of portfolio diversification, the impact of evolving financial markets, and why we believe tactical management is playing an increasingly pivotal role.

During the Great Recession, there were very few places for investors to turn.

Exhibit 1: Asset Class Returns—Calendar Year 2008[1]



1 Source: FactSet. **Performance displayed represents past performance, which is no guarantee of future results.** Index performance is for illustration purposes only and is not meant to represent any particular fund. Returns do not reflect any management fees, transaction costs, or expenses. The indices are unmanaged and not available for direct investment. The **S&P 500® Index** represents the large-cap equity market. **EAFE** (Europe, Australasia, Far East) is represented by the MSCI EAFE Index. **Emerging markets** are represented by the MSCI EM Index. **Real estate** is represented by the FTSE NAREIT All Equity REITs Index. **Commodities** are represented by the S&P GSCI Index. **High yield** is represented by the Bloomberg U.S. Corporate High Yield Index. **Bonds** are represented by the Bloomberg U.S. Aggregate Bond Index. Please see p. 5 for index definitions.

II. The Concept of Diversification

Diversification can best be conveyed in the oft-repeated statement "Don't put all your eggs in one basket." The concept underlying this statement assumes that all baskets will not break at the same time. Similarly, investors may diversify across multiple asset classes to seek some protection when certain segments of the market take a downturn. But what happens when, like in the Great Recession, the majority of asset classes experience a severe downturn at the same time, undermining the benefit of diversification? To understand the limits of diversification, it is important to understand what investors are trying to achieve by investing across multiple asset classes and the forces determining asset class prices.

When investors speak of diversification, they typically mean diversifying away from large-cap U.S. equities, because the S&P 500® Index, which includes the 500 largest companies in America, has become a proxy for equity markets in general. We are reminded of this every time we turn on business news and listen to how much the market is up or down and why.

While this focus on large-cap U.S. equities may appear myopic, it's interesting to note that the vast bulk of portfolio risk is generally related to U.S. equity volatility. Historically, approximately 85 percent of a typical diversified portfolio's volatility can be explained by large-cap U.S. equities.[1] So, the desire to diversify away from this risk seems logical. Investors seek to invest in asset classes that they believe will zig when the S&P 500 Index zags.

Now that we have identified what we believe investors are trying to achieve by investing across multiple asset classes, it would be helpful to understand what drives asset class prices.

Financial asset class prices are driven by buyer and seller behavior. Put simply, if there are more buyers than sellers, prices will generally increase. Likewise, if there are more sellers than buyers, prices will generally decrease. So, to understand the potential diversification benefits of investing across multiple asset classes, you need to anticipate buyer and seller behavior. For example, if you invest across five asset classes, all of which you expect investors to sell at the same time, it wouldn't be logical to expect that allocating across those asset classes would provide meaningful diversification.

Investors experienced a real life example of this in 2008. Fearful of a severe global economic downturn, investors did not just sell out of the S&P 500—they sold all asset classes they felt would be impacted by the downturn. Since money has to go somewhere, as investors sold "risky" asset classes most tied to the global economy, they bought perceived "less risky" or "safer" asset classes like bonds backed by the U.S. government and issued by the most credit-worthy corporations. As a result, this buyer and seller behavior drove down the prices of perceived "riskier" asset classes while driving up the value of perceived "safer" asset classes.

After 2008, many investors suggested that diversification stopped working. We believe this suggestion is incorrect and is premised upon a misunderstanding of how asset class diversification works. Most asset classes possess little inherent diversification quality. Their diversification benefits are derived from buyer and seller behavior, which can change over time. Diversification did not stop working in 2008; buyer and seller behavior adapted to evolving financial markets.

1 Source for calculation: Guggenheim Investments. Allocation comprised of 60% S&P 500, 40% Bloomberg U.S. Aggregate Bond Index. Time period: 1.1.2002–12.21.2021. **Past performance is no guarantee of future results.**

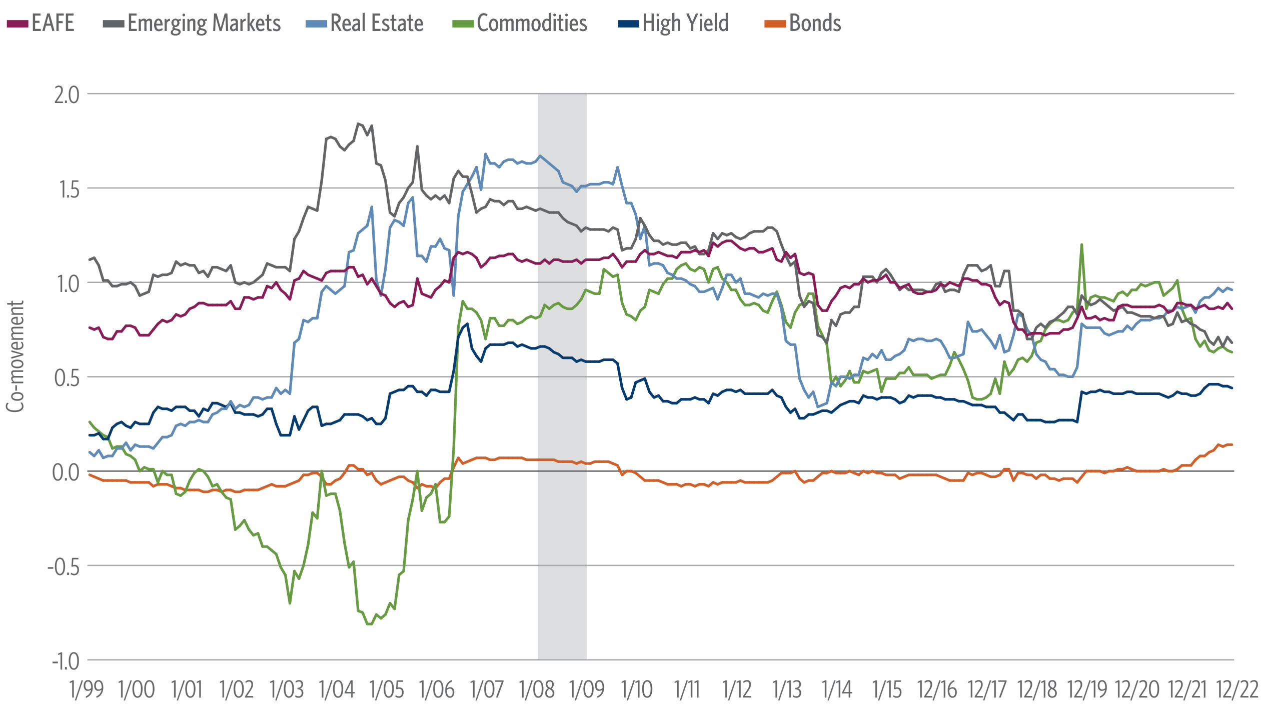
III. The Impact of Evolving Financial Markets

We believe that, over the last 20 years, two major interrelated developments have impacted asset class diversification. The first is the increased integration of the global economy and the second is financial product innovation or "financialization," which has allowed buyers and sellers to express their behavior more uniformly across asset classes tied to the global economy.

Consequently, as the chart below illustrates, leading up to 2008 and continuing in the current environment, there has been increased co-movement between a broad range of risk asset classes and the S&P 500. Driven by buyer and seller behavior, these increases in co-movement significantly reduced the ability to diversify away the risk associated with the S&P 500, which dominates portfolios.

Increased Co-movement—The chart below illustrates the co-movement of assets to the S&P 500® Index. A measurement of 1 represents a high level of co-movement with the S&P 500; any measurement above 1 is indicative of leveraged co-movement; and a measurement below 1 represents lower co-movement.

Exhibit 2: Co-movement of Assets to the S&P 500® Index[1] January 1999–December 2022



1 Source: Factset, as of 12.31.2022. **Performance displayed represents past performance, which is no guarantee of future results.** Index performance is for illustration purposes only and is not meant to represent any particular fund. Returns do not reflect any management fees, transaction costs, or expenses. The indices are unmanaged and not available for direct investment. **EAFE** (Europe, Australasia, Far East) is represented by the MSCI EAFE Index. **Emerging markets** are represented by the MSCI EM Index. **Real estate** is represented by the FTSE NAREIT All Equity REITs Index. **Commodities** are represented by the S&P GSCI Index. **High yield** is represented by the Bloomberg U.S. Corporate High Yield Index. **Bonds** are represented by the Bloomberg U.S. Aggregate Bond Index. Please see p. 5 for index definitions.

Even subsequent to 2008, “risk” assets, which are more tied to the global economy, have maintained historically high co-movements with the S&P 500, suggesting the effects of globalization and financialization are structural and not an aberration. As long as these forces are in place, it is reasonable to assume that during economic stress periods, allocating across “risk” asset classes may provide limited diversification benefit. With this said, there is likely nothing preventing these relationships between the S&P 500 and these other asset classes from continuing to change. It is important to recognize that as global financial markets evolve, so will buyer and seller behavior.

Given these developments in the financial markets, what options are available to investors in search of an effectively diversified portfolio?

IV. Investment Grade Bonds?

Historically, investment grade bonds have maintained a low co-movement, even in 2008, with the S&P 500. This is because as buyers and sellers sell “risk” assets, they buy perceived “safer” assets. This behavior seems logical and unlikely to change, so investment grade bonds should continue to be a good source of diversification from the risk associated with the S&P 500.

With equities likely set to fall and investment-grade corporate credit and structured credit yields at attractive levels, our view is that now is a good time for active managers to start allocating defensively and move up in credit quality. Investors should still be prepared for a bumpy ride.

As we have discussed, we should not expect risk assets classes to provide, we should not expect risk assets to provide high levels of diversification during stress periods, which is when diversification is needed most.

V. The Importance of Tactical Asset Allocation

Given low interest rates and increased co-movement between "risk" asset classes and the S&P 500, it is more difficult than ever for investors to balance risk and return using traditional strategic asset allocation strategies. Unlike strategic asset allocation strategies, which maintain static allocations to bonds and "risk" asset classes in good times and bad, tactical asset allocation strategies seek to increase or decrease a portfolio's risk exposure, based upon current market conditions.

While there are a number of different tactical approaches, most seek to capture the increased return potential of "risk" asset classes, including global equities, real estate, commodities, and high yield bonds, while managing the risk associated with these asset classes. In essence, they seek to replace the reduced diversification benefit of allocating across multiple "risk" asset classes with modulation of market risk.

VI. Summary

Due to the increased integration of the global economy, product innovation, and buyer and seller behavior, investors are finding it more difficult than ever to achieve effective diversification across risk asset classes. To complicate matters, the transition to a world of quantitative tightening will lead to reduced liquidity, capital rationing and persistent swings in asset prices.

Investors should consider more tactical asset allocation strategies, which seek to replace the reduced diversification benefit of allocating across multiple "risk" asset classes with modulation of market risk.

Term and Index Definitions

The S&P 500 Index is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

The MSCI EAFE Index (Europe, Australasia, Far East) is an equity index which captures large and mid cap representation across 21 developed markets countries around the world, excluding the U.S. and Canada. With 829 constituents, the index covers approximately 85% of the free float adjusted market capitalization in each country.

The MSCI Emerging Markets Index captures large- and mid-cap representation across 25 emerging markets (EM) countries. With 1,420 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The FTSE NAREIT All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. Constituents of the index include all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property.

The S&P GSCI Index is the first major investable commodity index. It is one of the most widely recognized benchmarks that is broad-based and production weighted to represent the global commodity market beta.

The Bloomberg U.S. Corporate High Yield Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency).

About Guggenheim Investments

Guggenheim Investments is the global asset management and investment advisory division of Guggenheim Partners and manages assets across fixed-income, equity, and alternative strategies. We focus on the return and risk needs of insurance companies, corporate and public pension funds, sovereign wealth funds, endowments and foundations, consultants, wealth managers, and high-net-worth investors. Our investment professionals perform rigorous research to understand market trends and identify undervalued opportunities in areas that are often complex and underfollowed. This approach to investment management has enabled us to deliver innovative strategies, providing diversification opportunities and attractive long-term results.

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